



JOHN ENGLER  
GOVERNOR

STATE OF MICHIGAN  
OFFICE OF THE STATE BUDGET  
LANSING

DON GILMER  
DIRECTOR

March 29, 2002

The Honorable John Engler, Governor  
Members of the Legislature  
People of the State of Michigan

As required by Article 9, Section 21, of the State Constitution and Section 494, Public Act 431 of 1984, as amended, we are pleased to submit the *State of Michigan Comprehensive Annual Financial Report* (SOMCAFR) for the fiscal year ended September 30, 2001.

### **INTRODUCTION TO THE REPORT**

**Responsibility:** The Office of the State Budget, Office of Financial Management, prepares the SOMCAFR and is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including disclosures. To the best of our knowledge and belief, the information contained in the SOMCAFR is accurate in all material respects and reported in a manner that fairly presents the financial position and results of operations of the State primary government and component units for which it is financially accountable. All disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial affairs have been included.

**Adherence to Generally Accepted Accounting Principles:** As required by State statute, we have prepared the financial statements contained in the SOMCAFR in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

**Report:** The SOMCAFR is divided into three major sections: introductory, financial, and statistical. The introductory section includes this letter, the State's organization chart, and the list of principal officials. The financial section includes: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A) which provides an introduction, overview and analysis to the "Basic Financial Statements"; the Basic Financial Statements, which present the government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with footnotes

to the Basic Financial Statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules and information about infrastructure assets; and the supplemental financial data which includes the combining financial statements and schedules. The statistical section includes such items as trend information, information on debt levels, and other selected economic and statistical data.

**Internal Control Structure:** The Office of the State Budget is responsible for the overall operation of the State's central accounting system and for establishing and maintaining the State's internal control structure. All financial transactions of the State primary government are recorded in the central accounting system, except for the Michigan Unemployment Compensation Funds, the State Employees' Deferred Compensation Funds, and the State Employees' Defined Contribution Retirement Fund. Many of the essential control features are decentralized, such as the preparation and entry of expenditure transactions into the central accounting system. Consequently, the Office of the State Budget relies upon the controls in place at the various State departments and agencies. The Management and Budget Act (Section 18.1483 – 18.1489 of the *Michigan Compiled Laws*) requires that the head of each principal department shall establish and maintain an internal accounting and administrative control system. The Act also requires that the heads of each principal department shall report biennially on any material inadequacy or weakness discovered in connection with the evaluation of their system. The *"Evaluation of Internal Controls – A General Framework and System of Reporting"*, developed in consultation with the Office of the Auditor General, provides the required guidance associated with the evaluation of internal controls in Michigan State government. The framework for internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement.

The Management and Budget Act requires each principal department to appoint an internal auditor and maintain adequate internal control systems. Each department is also required to periodically report to the Governor on the adequacy of its internal accounting and administrative control systems and, if any material weaknesses exist, to provide corrective action plans and time schedules for addressing such weaknesses. This reporting is required on or before May 1 of each odd numbered year, effective as of the preceding October 1.

The discretely presented component units generally operate outside the State's central accounting system and are responsible for establishing and maintaining their own separate internal control structures.

**Independent Auditors:** The Office of the Auditor General (OAG) audited the SOMCAFR with a goal to provide reasonable assurance that the SOMCAFR for the fiscal year ended September 30, 2001, is free of material misstatement. The OAG conducted the audit of the SOMCAFR in accordance with generally accepted auditing standards (GAAS), and its independent auditor's report precedes the Basic Financial Statements. The audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the CAFR; assessing the accounting principles used and evaluating the overall financial statement presentation. The OAG concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the SOMCAFR for the fiscal year ended September 30, 2001, is fairly presented in conformity with GAAP.

In addition to the annual audit of the SOMCAFR, the OAG also performs periodic financial and performance audits of the various State departments, agencies, and institutions of higher education. The OAG engages outside public accounting firms periodically, particularly for the audits of the separately issued component unit financial statements (such as the Michigan State Housing Development Authority), the larger pension (and other employee benefit trust) funds, and the Michigan Unemployment Compensation Funds. The Auditor General also has primary responsibility for conducting audits under the federal Single Audit Act of 1984. Pursuant to Michigan Public Act 251 of 1986, these audits are conducted biennially for applicable State departments, agencies, and component unit authorities, and result in separately issued audit reports.

**Management's Discussion and Analysis (MD&A):** GASB Statement No. 34 requires that management provide a narrative introduction, overview and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

## **PROFILE OF THE GOVERNMENT**

**Reporting Entity:** The State of Michigan reporting entity reflected in the SOMCAFR, which is described more fully in Note 1 to the basic financial statements, conforms with the requirements of GASB Statement No. 14, The Financial Reporting Entity. The accounting and reporting principles contained in Statement No. 14 are based primarily on the fundamental concept that publicly elected officials are accountable to their constituents. Further, Statement No. 14 provides that the financial statements should emphasize the *primary government* and permit financial statement users to distinguish between the primary government and its *component units*. Consequently, the transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

**Budgetary Reporting and Control:** For the State primary government operating funds (i.e., the General Fund and annually appropriated special revenue and permanent funds), Public Act 431 of 1984, as amended, requires the State to adhere to GAAP in budgeting projected revenues and expenditures and calculating fund balance for budgetary purposes. The Act also prohibits the State from budgeting for an ending fund balance deficit in an operating fund. If an actual deficit is incurred, the Constitution and Act 431 require that it be addressed in the subsequent year's budget. If accounting principles change, Act 431 requires the State to also implement such changes in its budgetary process.

The budgetary "basis of accounting" used by the State primary government departs from GAAP only in ways that do not affect unreserved fund balance, and that do not impact most revenue and expenditure line items. Appropriations for nearly all line items, therefore, are made on a basis consistent with GAAP, which makes it possible for the State to use the central accounting system for both budgetary control and financial reporting purposes. The two variances between GAAP and the budgetary basis of accounting are: 1) the use of encumbrances for budgetary control purposes (which GAAP does not require), and 2) the timing of recording expenditures and liabilities for capital lease commitments on a "pay as you go" basis for budgetary purposes, rather than at lease inception as required by GAAP. Compliance with the final updated budget for the annually budgeted operating funds of the State primary government is demonstrated in the budget and actual comparative schedules and notes in the SOMCAFR.

**Revenue and Spending Limitation Requirements:** Under the State Constitution, total State revenues are limited to a percentage of total Michigan personal income. If the limit is exceeded by an amount less than 1%, the excess may be transferred to the Budget Stabilization Fund. If revenues exceed the limit by 1% or more, the amount in excess must be refunded to payers of personal income and single business taxes. The calculations necessary to determine the State's compliance with this requirement for fiscal year 2000-2001 are not final. For fiscal year 1999-2000, the most recent year for which final calculations are available, total State revenues subject to this limitation exceeded the limit by \$159.7 million. The State expects that total State revenues subject to the limitation will not exceed the limit for fiscal year 2000-2001.

The State Constitution also requires that spending to local units of government be maintained at not less than a specified level of total State spending, originally determined to be 41.61% for the base fiscal year 1978-79. The originally determined percentage was recalculated, effective fiscal year 1992-93, reflecting the terms of a legal settlement agreement. The recalculated base year percentage is 48.97%. The calculations necessary to determine the State's compliance with this requirement for fiscal year 2000-2001 are not final. For fiscal year 1999-2000, the most recent year for which final calculations are available, the proportion of total State spending paid to local units of government was determined to be 61.68%, reflecting payments that exceeded the minimum required by \$3.0 billion. The State expects that payments to local units of government will exceed the minimum requirement for fiscal year 2000-2001.

The State's status, with regard to these Constitutional provisions, is discussed more fully in Note 3 to the basic financial statements.

## **ECONOMIC CONDITIONS AND OUTLOOK**

Fiscal year 2001 began with continuing national and state economic growth although at a much slower rate than the previous fiscal year. However, economic indicators reflected an overall leveling or temporary cooling in the economy. America finds itself in the midst of an economic downturn, predicted by analysts but exacerbated by the tragedies of September 11<sup>th</sup>. The last several months have forced the nation to face the unimaginable. Beyond the human tragedy, the September attacks and subsequent related events have inflicted economic pain that contrasts sharply with the preceding decade of prosperity and growth. Michigan has not been immune to these recent events. The impact of the recession is being widely observed. The U.S. economic slowdown that began in March 2001 ended the longest recorded economic expansion of ten years. Automakers made the most aggressive production cuts in a decade and offered zero percent financing to boost car sales beginning in October 2001. Michigan's economy also slowed, causing employment to decline. The unemployment rate averaged 5.0 percent in 2001, up from 3.6 percent a year ago. As a result, budgets for fiscal year 2001 and 2002 were adjusted downward to reflect softening revenues. In December 2001, economic indicators suggested the economy was turning the corner toward recovery. New claims for unemployment benefits had fallen sharply, employment declines slowed and consumer and business confidence improved. These fundamentals indicate the underlying economy is sound and the long-term outlook for Michigan is positive.

Inflation, as measured by the Detroit CPI, is forecast to be a moderate 2.4 percent in 2002 and 3.0 percent in 2003. As a result, real Michigan personal income (inflation adjusted) is expected to remain unchanged in 2002 before rising to a solid 2.2 percent in 2003. Michigan wage and salary employment is forecast to decline by 33,000 (0.7 percent) in 2002, and is forecast to rise by 79,000 (1.7 percent) in 2003. Personal income growth is forecast to slow to 2.4 percent in 2002, and post solid growth of 5.3 percent in 2003.

## **MAJOR INITIATIVES AND FUTURE PROJECTS**

**Education Remains a Top Priority:** Education has been and continues to be critically important to the State. More than \$14.7 billion, or 39 percent, of the State's overall budget is devoted to education in fiscal year 2001-2002. This includes funding for the K-12 system, universities, community colleges and student financial aid. In fiscal year 2001, the State spent more on K-12 education than it spent on expenditures financed by General Fund general purpose revenues.

The Administration is committed to increasing the minimum foundation allowance to \$6,700 per pupil in fiscal year 2003. This \$200 (3.1 percent) per pupil increase will cost \$337 million and will require a change in the State education tax collection structure in fiscal year 2003.

**Transportation Infrastructure Investments:** The Build Michigan I, II, and III financing programs have resulted in record investments in Michigan's transportation infrastructure. In fiscal year 2001-2002, the Department of Transportation will invest over \$1.5 billion in the state trunkline system, making it the fifth year in a row that the Michigan transportation program has exceeded the billion-dollar mark.

**Technology Consolidation:** As part of a bold plan to keep Michigan on the cutting edge of technological change, all information technology management functions were moved to the new Michigan Department of Information Technology, effective October 2001. The department will establish a long-term strategy that allows for better management of technology investments, improved information management and more efficient services to citizens.

**Central Electronic Payment Authorization System:** The e-Michigan Office continues to search for an enterprise-wide electronic payment module that provides flexibility to support multiple payment instruments and makes State government more accessible to its citizens. Citizens will access the award-winning Web site "Michigan.gov" (<http://www.michigan.gov>) and use major credit cards and other electronic payment transactions to purchase the diverse services provided by the state, such as license renewal and camping reservations.

**Child Support Enforcement System:** The Family Independence Agency implemented a statewide integrated child support network that coordinates all employer withholdings for child and spousal support and disbursements to custodial families. The use of electronic funds transfer and electronic data interchange contributes to the effective processing and efficiencies gained from using a single location. FIA processes approximately \$80.0 million per month to custodial families.

**Financial Management Reporting Improvements:** The Office of the State Budget (OSB) continues to lead a statewide effort to reduce the time and cost of the annual bookclosing process that produces the SOMCAFR. OSB has set a statewide goal to produce the fiscal year 2002 SOMCAFR by December 31, 2002. This endeavor will require the collective effort from all accounting and financial personnel throughout State government.

## **FINANCIAL INFORMATION**

The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, MD&A focuses on the State's major funds: the General Fund, Budget Stabilization Fund, School Aid Fund, State Lottery Fund, and the Michigan Unemployment Compensation Funds. Fiduciary activities are excluded from the MD&A.

**Cash Management and Investments:** As discussed more fully in Notes 5 and 8 to the basic financial statements, the State Treasurer maintains the State's Common Cash pool, which is used by most State funds for short-term investments and to provide centralized control over disbursements. The total amount of pooled cash, which is primarily invested in prime commercial paper, amounted to \$4.8 billion at September 30, 2001, a decrease of approximately \$700 million from \$5.5 billion at September 30, 2000. Total investments amounted to \$53.7 billion at September 30, 2001, a decrease of \$7.2 billion from \$60.9 billion at September 30, 2000. Pension (and other employee benefits) trust fund investments represent 91.3 percent of the total investments held by the state.

**Debt Management:** The State Constitution authorizes general obligation long-term borrowing, subject to approval by the Legislature and a majority of voters at a general election. General obligation bond issues totaled \$324.6 million during 2000-2001. The bonds provide financing for

the Clean Michigan Initiative Program and school district loans.

Long-term bonds have been issued periodically for specific purposes, with the stipulation that financing of debt requirements is to come strictly from designated revenue sources. Revenue dedicated bonded debt, including that of the State Building Authority, increased by \$603.8 million to \$3.4 billion during 2000-2001. The bonds provide financing for building new state and university facilities and road and bridge construction.

The State Constitution provides that the Legislature may authorize the issuance of short-term general obligation notes to assist in managing cash flows. Such borrowings are limited by the Constitution to 15% of undedicated State revenue received in the preceding year. The Constitution also requires that such borrowings be repaid before year-end. No such borrowings occurred during the fiscal year.

Additional disclosures about the State's general long-term obligations are provided in Note 14 to the basic financial statements.

Pension Plans: The State Constitution requires the State to provide current funding of plan benefits for the State's defined benefit pension plans. Statutes provide for the amortization of unfunded prior service costs. In two of the four plans for which the State is responsible for providing funding, the enabling statutes for the plans contain provisions under which a shortfall in the legally required contributions will be corrected in succeeding fiscal years.

The State Employees' Retirement System (SERS) is the largest of the defined benefit plans for which the State is responsible for providing funding. Total assets of SERS at September 30, 2001 were \$10.1 billion, with net assets held in trust for pension and postemployment health-care benefits totaling \$9.6 billion. Additional disclosures relating to the State's pension funds are provided in Note 11 to the financial statements.

Risk Management: Risk management was established within the Department of Management and Budget in 1987 to improve the State's risk control policies and procedures. The unit's activities include analysis of and control over

insurance coverage and risk exposure, and planning and implementing a statewide safety and health policy and program. The State is self-insured for many types of general liability and property losses. Additional disclosures on the State's risk management activities are provided in Note 27.

## **OTHER INFORMATION**

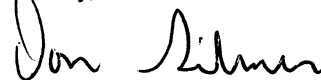
Certificate of Achievement: The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Michigan for its SOMCAFR for the year ended September 30, 2000. The Certificate of Achievement is a prestigious national award, recognizing conformance with the highest standards for preparation of state and local government financial reports.

To be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

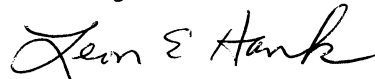
A Certificate of Achievement is valid for a period of one year only. The State has received a Certificate of Achievement for the last fourteen consecutive years. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA for review.

Acknowledgments: In any year, the preparation of this report requires the collective efforts of literally hundreds of finance personnel throughout the State, both individually and in teams from virtually all agencies and departments. We sincerely appreciate the dedicated efforts of all of these individuals. This year, we implemented several new GASB standards, including Statement No. 34 requirements, one year earlier than required. Achieving this is the result of the dedicated management and staff of the Financial Control Division, Office of Financial Management; the chief financial officers, chief accountants, and their staffs; and the management and staff of the Office of the Auditor General; who continue to strive for improvements that will result in Michigan being a national leader in quality and efficiency for financial reporting.

Sincerely,



Don Gilmer  
State Budget Director



Leon E. Hank, CPA  
Director, Office of Financial Management